Office - Supreme Court, U.S.
FILED
NOV 19 1981
ALEXANDER L. STEVAS,
CLERK

No. 80-2204

In the Supreme Court of the United States

October Term, 1981

VICTOR P. DIEDRICH and FRANCES T. DIEDRICH,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

and

UNITED MISSOURI BANK OF KANSAS CITY, N.A., EXECUTOR OF THE ESTATE OF FRANCES D. GRANT, DECEASED,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

AMICUS CURIAE BRIEF

On Behalf of Ralph Owen and Lulu H. Owen; John T. Benson, Jr. and Jimmie L. Benson; J. C. Bradford, Sr. and Eleanor Bradford; Joe C. Davis; and Estate of Frances Hampton Currey

WILLIAM WALLER
(Counsel of Record)
WALLER LANSDEN DORTCH & DAVIS
2100 One Commerce Place
Nashville, Tennessee 37239
(615) 244-6380
Attorney for Amici Curiae

E. L. MENDENHALL, INC., 926 Cherry Street, Kansas City, Mo. 64106, (816) 421-2030

TABLE OF CONTENTS

Interest of the Amici Curiae 2

Summary of Argument 8

Argument:

- Structure of a Net Gift 10
- The Commissioner's Theory of Tax Liability 12
- The Tax Reform Act of 1976 14
- The Crane Case 16
- The Constitutional Concept of Income 19
- The Weight to Be Given the Tax Court Decisions 21

Conclusion 25

Table of Authorities

CASES

Arrowsmith v. Commissioner, 344 U.S. 6, 12 (1952) 24

John T. Benson, Jr., et ux. v. Commissioner, T.C. Memo 1978-231 6

Eleanor A. Bradford v. Commissioner, 233 F.2d 935 (6th Cir. 1956) 20

J. C. Bradford, et ux. v. Commissioner, 70 T.C. 584 (1978) 6

Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, 406 (1932) 24

Cannon v. Apperson, 14 LEA (82 Tenn.) p. 553 12

Chevron Oil Co. v. Huson, 404 U.S. 97, 105-109 (1971) 25

Commissioner v. Rail Joint Co., 61 F.2d 751 (C.A. 2, 1932) 20, 21

Crane v. Commissioner, 331 U.S. 1 (1947) 5, 8, 16, 17, 18, 19

Joe C. Davis v. Commissioner, 74 T.C. 881 (1980) 6

Diedrich v. Commissioner, 643 F.2d 499 (8th Cir. 1981) 7, 11
Dobson v. Commissioner, 320 U.S. 489 (1943) 24
Edwards v. Cuba Railroad, 268 U.S. 628 (1924) 21
Est. of Frances H. Currey v. Commissioner, T.C. Memo 1981-40 6
Est. of Davis v. Commissioner, T.C. Memo 1971-318, (30 T.C.M. 1363), affd. 469 F.2d 694 (5th Cir. 1972) 4, 19, 22
Est. of Henry v. Commissioner, 69 T.C. 665 (1978) 7
Est. of King v. Commissioner, 37 T.C. 973 (1962) 22
Evangelista v. Commissioner, 629 F.2d 1218 (7th Cir. 1980) 12, 17
Hanover Bank, Executor v. Commissioner, 369 U.S. 672 (1962) 25
Sarah Helen Harrison v. Commissioner, 17 T.C. 1350 (1952) 2, 11, 14
Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940) 20
Hirst v. Commissioner, 572 F.2d 427 (4th Cir. 1978), 63 T.C. 307 (1974) 4, 6, 7, 10, 11, 12, 13, 15, 25
Johnson v. Commissioner, 495 F.2d 1079 (6th Cir. 1974), 59 T.C. 791 (1973) 4, 5, 6, 7, 8, 9, 12, 13, 16, 18, 19
Krause v. Commissioner, 56 T.C. 1242 (1971) 4, 6, 10, 14, 21
Magnolia Development Co. v. Commissioner, T.C. Memo 1960-177 (19 T.C.M. 934) 5, 12, 19
Millar v. Commissioner, 577 F.2d 212 (3rd Cir. 1978), cert. denied 439 U.S. 1046 (1978) 18
National Bank v. Whitney, 103 U.S. (13 Otto) 99 (1880) 23
Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929) 5, 8, 13, 16

Owen, et ux. v. Commissioner, T.C. Memo 1978-51, 652 F.2d 1271 (6th Cir. 1981) 6, 7, 10, 12, 18, 24
Reinecke v. Northern Trust Company, 278 U.S. 339 (1929) 22
Simon v. Commissioner, 285 F.2d 422 (3rd Cir. 1960), affg. 32 T.C. 935 ..... 5, 12, 19
Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981) 18
Turner v. Commissioner, 49 T.C. 356 (1968), affd. 410 F.2d 752 (6th Cir. 1969) 3, 4, 5, 6, 8, 21, 24
United States v. Byrum, 408 U.S. 126 (1972) 22

STATUTES

Internal Revenue Code of 1939 8
Internal Revenue Code of 1954 (U.S.C.):
Section 61 ..... 19, 20
Section 644 ..... 9, 15
Section 671 ..... 3, 4, 11, 21
Section 677 ..... 3, 4, 11, 21
Section 1001(a) 8, 16, 17
Section 1015(d)(6) 16
Section 2036(a)(2) 22

MISCELLANEOUS

Rev. Rul. 57-564, 1957-2, Cum. Bull. 328 3
Rev. Rul. 75-72, 1957-1, Cum. Bull. 310 3
Sixteenth Amendment 9, 19, 20, 21
Tax Reform Act of 1976:
Section 701(e) 14
Section 2005(c) 16
Judicial Code Act of June 25, 1948, 36, 62 Stat. 991-992 24
Virginia Bill of Rights, 1776 Paragraph 15 19

Federal Taxation of Income, Estates and Trusts, Boris J. Bittker (1981) para. 43.1 17

Ways and Means Committee Report:

H. Rpt. No. 94-658, 94th Congress, 1st Sess., Nov. 12, 1975, p. 183 14

H. Rpt. No. 94-1380, 94th Congress, 2d Sess., August 2, 1976, p. 44 16

Conference Report

H. Rpt. No. 94-1515, 94th Congress, 2d Sess., Sept. 13, 1976, p. 441 15

No. 80-2204

In the Supreme Court of the United States

October Term, 1981

VICTOR P. DIEDRICH and FRANCES T. DIEDRICH,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

and

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
EXECUTOR OF THE ESTATE OF FRANCES D. GRANT,
DECEASED,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

AMICUS CURIAE BRIEF

On Behalf of Ralph Owen and Lulu H. Owen; John T. Benson, Jr. and Jimmie L. Benson; J. C. Bradford, Sr. and Eleanor Bradford; Joe C. Davis; and Estate of Frances Hampton Currey

MAY IT PLEASE THE COURT:

This *amicus curiae* brief is filed in support of the position of Petitioners in this case on behalf of the following

appellees in cases pending in the Sixth Circuit Court of Appeals:

Ralph Owen and Lulu H. Owen

John T. Benson, Jr. and Jimmie L. Benson

J. C. Bradford, Sr. and Eleanor Bradford

Joe C. Davis

Estate of Frances Hampton Currey

INTEREST OF THE AMICI CURIAE

The interest of the *amici curiae* can best be seen from the following historical survey.

The first reference to net gifts we find in court decisions was in *Sarah Helen Harrison v. Commissioner*, 17 T.C. 1350 (1952), involving the amount of the gift tax. The Commissioner of Internal Revenue contended that the gift tax should be applied to the gross gift. In ruling for the taxpayer the Tax Court said (p. 1357):

> Respondent asserts that gift tax "is measured by the value of the property passing from the donor." Regulations 108, section 86.3. This is true if the property passes from the donor with all the elements of a gift. Cf. *Commissioner v. Hogle*, 165 F.2d 352, 353, affirming 7 T.C. 986. One of the essential elements of a gift is the donor's intention to make the gift. Petitioner did not intend that the amount of the value of the property necessary for the gift tax liability would be a gift to the trust. Therefore, in the absence of an intent to give, this amount was not effective as property passing from the donor, and not taxable as a gift.

As used in the brief and in the cited cases, a net gift is a gift on condition that the donee pay the gift taxes or that the donee agree to pay the gift taxes.[1]

In Rev. Rul. 57-564, 1957-2 Cum. Bull. 328, the Commissioner responded to a request ". . . with respect to the Federal income tax consequences to a donor, pursuant to a trust instrument, requiring the donee trust to pay the Federal gift tax on the gift of such stock. . . ." The Commissioner ruled that ". . . income of the trust which is applied by the trustee in satisfying the obligation incurred to pay gift tax of the donor, is taxable to the donor under the provisions of Section 677 of the Code." There was no suggestion of any other "income tax consequences" and the implication of this omission was that there were none. Certainly there was no administrative construction of any Federal tax law that there were such consequences prior to the cases now to be referred to.

The first decided case in which the I.R.S. made the contention that a capital gain was realized by a donor who made a net gift where the gift tax exceeded the donor's basis in the donated property was *Turner v. Commissioner*, 49 T.C. 356 (1968).[2] The Tax Court rejected the conten-

---

1. Assuming a gross gift of $1,000, and a Federal gift tax rate of 25%, the formula to arrive at the amount of the net gift would be: $X + 25/100\ X = 1{,}000$; $125\ X; = 100{,}000$; $X = 800$. The computation becomes more complicated when different gift tax brackets are involved and when the gift is considered as made one-half by the donor and one-half by his spouse. See Rev. Rul. 75-72, 1957-1, Cum. Bull. 310. In this brief, for the sake of simplicity, state gift taxes will be ignored.

2. The Commissioner argued for a capital gain tax only in the case of a gift to an individual, conceding that there was none in the case of a gift to a trust. The reason for the concession is unclear, but was possibly on the theory that the only income tax consequences of a net gift to a trust were those based on Sections 671 and 677 of the Code. In later cases the Commissioner made the same argument whether the gift was to a trust or to an individual.

tion; the Commissioner appealed to the Sixth Circuit Court of Appeals, and that Court affirmed the Tax Court, 410 F.2d 752 (6th Cir. 1969). The same contention was then made and rejected by the Tax Court in *Estate of Davis v. Commissioner,* T.C. Memo 1971-318 (30 T.C.M. 1363); the Commissioner appealed to the Fifth Circuit Court of Appeals, and that Court affirmed the Tax Court, 469 F.2d 694 (5th Cir. 1972). Then again in *Krause v. Commissioner,* 56 T.C. 1242 (1971), the Commissioner advanced the same contention as an alternative to his contention that the use of proceeds of sale of donated property for payment of the gift taxes resulted in income to the donor. The Tax Court, in an opinion reviewed by the Court, held with one judge dissenting, that the taxpayers realized income under Sections 671 and 677 of the Code in the amount of the income received by the trusts *prior* to the payment of the gift tax liabilities, but unanimously held that they did not realize any other income as a result of the payment of such taxes. Both parties appealed to the Sixth Circuit Court of Appeals, but both parties then dismissed their appeals on June 27, 1972.

There was no other case pending in any other circuit in which the Commissioner was making the contention now made, except *Hirst v. Commissioner,* 63 T.C. 307 (1974). In view of the state of the law, it is likely that the Commissioner would not have pursued the *Hirst* case had it not been for a decision of the Sixth Circuit Court of Appeals in *Johnson v. Commissioner,* 495 F.2d 1079, decided April 9, 1974. This is the case on which the Eighth Circuit Court of Appeals mainly relied in the instant cases. The facts in *Johnson* were that the taxpayers, who owned corporate stock of high value but a low tax basis, borrowed money on non-recourse notes from a bank and then made gifts of the stock to trusts, subject to the encumbrances of

the bank loans. The donors paid the gift taxes on the gross gifts, using part of the proceeds of the bank loans to do so, but were free to use these proceeds any way they chose.

Prior to the *Johnson* transactions, there had been at least two decisions with facts almost identical in which the Commissioner had prevailed. These were *Simon v. Commissioner*, 285 F.2d 422 (3rd Cir. 1960), affirming 32 T.C. 935, and *Magnolia Development Company v. Commissioner*, T.C. Memo 1960-177 (19 T.C.M. 934). The factual differences were that in *Simon* the gift was to a controlled corporation and in *Magnolia Development Co.* the gift was to a charity, so that in neither case were gift taxes involved. In each case it was held that the fact that the donor had borrowed the money and then transferred the property was a matter of form rather than substance and that the donee in each case was really buying the property for the amount of the loan. These cases were presumably known to the Johnson brothers or their tax counsel when they engaged in the transactions in controversy, but by the time deficiency notices were issued, *Turner* had been decided, and they decided to contest the deficiencies on the ground that they also had "in substance" made net gifts. The Tax Court disagreed, and they appealed to the Sixth Circuit Court of Appeals, where they found a sympathetic ear. The panel of that Court which heard the case, in an opinion by Judge Celebrezze, affirmed the Tax Court, but in doing so took occasion, in *dicta*, to disapprove *Turner*. Reliance for this view was placed on *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) and *Crane v. Commissioner*, 331 U.S. 1 (1947). Neither of these cases had been relied upon in *Simon* or in *Magnolia Development Co.*, although Judge Bruce, for the Tax Court in *Johnson v. Commissioner*, 59 T.C. 791 (1973), had partially relied upon *Crane*, saying that its "rationale" had been applied "in

situations analogous in many respects to the present case." (p. 810). As to *Turner*, Judge Bruce said that it was "distinguishable both on the facts and the issues presented." (p. 812). There was no one to urge the correctness of *Turner* before the *Johnson* Court. The Commissioner argued that its was incorrectly decided, and the taxpayers' main thrust was that they should have the benefit of the decision although they had not made net gifts.

It was in 1972 and 1973, *after* the dismissal of the appeals in *Krause*, and prior to the decision in *Johnson*, that the gifts of the taxpayers, who are the *amici curiae* in these cases, were made. Solely as a result of the *dicta* in *Johnson*, the Internal Revenue Service reactivated its position that such gifts generated taxable income. Statutory notices were duly issued, and petitions duly filed with the Tax Court for redetermination of the deficiencies. The opinions in the Tax Court, all in favor of the taxpayers on this issue, were as follows:

Ralph Owen, et ux.	No. 8960-75, T.C. Memo 1978-51 filed Feb. 6, 1978
John T. Benson, Jr., et ux.	No. 5885-76, T.C. Memo 1978-231 filed June 21, 1978
J. C. Bradford, et ux.	No. 5701-76, 70 T.C. 584 (1978) filed July 31, 1978
Joe C. Davis	No. 5831-76, 74 T.C. 881 (1980) filed July 31, 1980
Estate of Frances F. Currey	No. 2219-78, T.C. Memo 1981-40 Feb. 2, 1981

The Tax Court did not hear the *Hirst* case until after the decision of the Sixth Circuit Court of Appeals in *Johnson*. It then reaffirmed its prior decisions in spite of the *dicta* in *Johnson* upon which the Commissioner had

relied. The Commissioner appealed to the Fourth Circuit Court of Appeals, which, after an *en banc* hearing, by a vote of five to three, affirmed the Tax Court in an opinion by Chief Judge Haynesworth, *Hirst v. Commissioner,* 572 F.2d 427 (4th Cir. 1978). Subsequently, the Tax Court decided the cases pending before it and the Commissioner promptly appealed all of them. Oral argument was heard in the Sixth Circuit in only one of these cases, *Owen v. Commissioner,* No. 78-1341. This case was decided by the Tax Court February 6, 1978, T.C. Memo 1978-51, and was orally argued on appeal June 6, 1980, and finally decided June 23, 1981 on the basis of *stare decisis. Owen v. Commissioner,* 652 F.2d 1271 (6th Cir. 1981). Meanwhile, in the Eighth Circuit, the two cases now before the Court, decided by the Tax Court on November 8, 1979, T.C. Memo 1979-441, and February 27, 1980, T.C. Memo 1980-50, respectively, were argued on January 15, 1981, with a decision in favor of the Commissioner on March 4, 1981, *Diedrich v. Commissioner,* 643 F.2d 499 (8th Cir. 1981). In all the Sixth Circuit cases the Commissioner's argument both in the Tax Court and in the Court of Appeals has been that the cases were "controlled by *Johnson,*" and in the Eighth Circuit *Johnson* was strongly relied upon.

In addition to the cases of the *amici curiae,* there is also pending in the Sixth Circuit the Commissioner's appeal from the Tax Court's decision in *Estate of Henry v. Commissioner,* 69 T.C. 665, filed February 6, 1978. All of these cases are being held in abeyance pending the decision of this Court in the present cases. In the *Owen* case the court has granted the Commissioner's Petition to Rehear En Banc and the case has been restored to the docket as a pending appeal.

SUMMARY OF ARGUMENT

Where a donor makes a gift of appreciated property to a donee in a lower tax bracket, e.g., a trust which distributes all its income except capital gains, and the donee sells the property, or a part of it, his capital gain tax is naturally less than the donor's tax would have been if the donor had sold the same property. Hence, when a donor makes a gift of appreciated property on condition that the donee pay the gift taxes, or that he agree to pay them, and the donee sells some of the property to raise the necessary funds, the Internal Revenue Service collects a smaller amount of capital gain taxes than if the donor had sold the same property to pay the same gift taxes. This is the tax advantage of making so-called net gifts.

The Commissioner of Internal Revenue contends in these cases and in the cases involving the *amici curiae* that where the gift taxes exceed the basis of the donated property, the excess is a capital gain to the donor, relying largely upon *Old Colony Trust Company* and *Crane*, which were also relied upon by the Sixth Circuit Court of Appeals in the *Johnson dicta* disapproving *Turner*. Neither of these cases support the Commissioner's contention. *Old Colony* involved the indirect payment of additional compensation to an employee in the form of the payment of his income taxes and the decision is applicable only in such an income-generating context. It is not applicable in non-commercial transactions between family members. *Crane* involved a taxable "disposition" of property and determined the "amount realized" under the provision of the 1939 Code which corresponded with Section 1001(a) of the 1954 Code. In the cases at bar, the "disposition" of the property was not a taxable disposition, and *Crane* is inapplicable. Moreover, *Crane* involved a sale of de-

preciable real estate on which the taxpayer had taken sizable depreciation deductions over a period of years, and this was said by the Court to be the "crux" of the case. The Court was careful to point out what it was not deciding. The Eighth Circuit Court of Appeals was incorrect, in the cases at bar, in treating the *Johnson* type of transaction the same as a pure net gift.

This Court should give great weight to the numerous decisions of the Tax Court holding that net gifts do not generate taxable income and to the fact that when these gifts were made, all prior to the *Johnson* decision, the law was well settled in favor of the taxpayers, both in the Tax Court and in the Sixth Circuit where the *amici curiae* all resided. Moreover, the concept of taxable income envisioned by the *Johnson* Court and the Eighth Circuit Court of Appeals in these cases is contrary to the concept of income under the Sixteenth Amendment.

At any rate, the remedy, if one was needed, was for Congress to apply, and Congress, in the Tax Reform Act of 1976, enacted such reforms as it considered necessary, including the incorporation of Section 644 into the Internal Revenue Code, imposing on donee trusts which sell property within two years of the transfer of the property a special (but non-retroactive) tax equivalent to any tax bracket savings otherwise realized by the donee trust as compared with the tax which would be imposed on the donor if the donor had sold the same property. The Commissioner in these cases seeks to have a special tax imposed by judicial fiat, not on the donee, but on the donor, creating in the case of net gifts to trusts an incongruous situation.

Finally, should the Court agree with the Commissioner and affirm the reversals of the Tax Court by the Eighth Circuit Court of Appeals, the reversals of the Tax Court should be non-retroactive.

ARGUMENT

Structure of a Net Gift

The simplest form of a net gift is a gift of money. Assuming a gift tax rate of 25%, the donor who makes a net gift of $800 will make a gross gift of $1,000, and the additional $200 does not "vanish into thin air", to use the language of Judge Raum in *Hirst* (63 T.C. at p. 315); it goes into the United States Treasury. Obviously, the tax consequences are exactly the same whether the donor makes a gift of $800 and pays the gift tax of $200, or makes a gift of $1,000 conditioned on payment of the gift tax by the donee.

The next simplest form would be a gift of property, plus enough money to pay the gift tax; eg. shares of stock worth $800, plus $200 in money. Here, as pointed out by Judge Featherston in *Krause*, the transfer of money in the amount of the gift tax, and the use of the money for payment of the gift tax, would not generate taxable income. The donee simply pays the money into the Treasury as before. Again, the tax consequences are exactly the same as if the donor had made a gift of the property only, and paid the gift tax himself.

The usual form of net gift, however, would be (using the same figures) a gross gift of shares of stock of a value of $1,000, in which case the donee could sell $200 worth and pay the gift tax. This was the form of net gift involved in *Owen*, where the exact language of each of the trust agreements was as follows:

(d) This gift is on the express condition that the Trustee report and pay out of the trust estate all gift taxes, both state and federal, which may be imposed upon donor by virtue of this gift. The Trustee is authorized to borrow the money with which to pay said taxes, or any part thereof, and to repay said loan or loans by selling, from time to time, property comprising a part of the trust estate. The interest on said loan or loans may be paid out of the income of the trust or by selling property in the trust estate, in the sole discretion of the Trustee.

To avoid any impact of Sections 671 and 677 of the Code, the trusts borrow the money for the gift taxes and after payment sell enough of the property to repay the loans. The *only* tax disadvantage to the Treasury is that it receives less capital gain taxes than if the donor, in a higher tax bracket, had made the sale to raise the necessary funds for the gift taxes.

A variation of this form of net gift would be one in which the donee pays the gift tax with his own funds, which would probably be the residue of taxable income after payment of income taxes. Such was the form of net gift described in *Sarah Helen Harrison*, and also the form of net gift in *Hirst*, where real estate was donated.

In *Diedrich*, the Court said in Footnote 7, that the characterization of a transaction for gift tax purposes is irrelevant in a case involving income taxes. Obviously the income tax consequences of a transaction are different from the gift tax consequences, but the transaction itself is the same. If the transaction is a non-commercial transaction for gift tax purposes, it is also a non-commercial transaction for income tax purposes, and if the donee is merely the conduit for the payment of the gift taxes in the gift

tax context, he remains merely a conduit in the income tax context.

Another variation in the form of net gifts is that the gift may be conditioned either on the payment of the gift tax by the donee, or on the agreement of the donee to pay the tax. Here we run into the distinction between a condition and a covenant, and if the gift is conditional, the distinction between a condition precedent and a condition subsequent. It is submitted that the gift in *Owen* was on a condition precedent. In other words, the gift was not a completed gift until the payment of the gift tax. See *Cannon v. Apperson*, 14 LEA (82 Tenn.) p. 553, opinion by Judge William F. Cooper, one of Tennessee's most distinguished jurists, holding that when a condition upon which a legacy depends is precedent, the legatee has no vested interest until the condition is performed.

The Commissioner's Theory of Tax Liability

Prior to the decision of the Sixth Circuit Court of Appeals in *Johnson*, the Commissioner consistently contended in the net gift tax cases that the taxpayer made a sale of the donated property for the amount of the gift tax, and a gift to the extent that the market value of the donated property exceeded the amount of the gift tax. One difficulty with this approach, as indicated in the opinion of Judge Raum in *Hirst* (63 T.C. at p. 315), was that if the basis of the donated property exceeded the amount of the gift tax, the taxpayer would have a recognizable loss. This was also pointed out in *Evangelista v. Commissioner*, 629 F.2d 1218 (7th Cir. 1980).

Johnson was in all significant respects similar to *Simon v. Commissioner, supra*, and *Magnolia Development Company, supra*, where the courts regarded the transactions as part gifts, part sales. When *Johnson* reached the Sixth

Circuit Court of Appeals, however, that Court rejected the part gift, part sale theory, and advanced a new theory, which was apparently thought to satisfy both the *Johnson* type of transaction and the net gift type of transaction; viz. the theory of economic benefit, bottomed largely on *Old Colony Trust Company*, where a corporate officer was held to have derived additional compensation from the payment of his income taxes by his employer. The Court theorized that the donor is "primarily liable" for the gift tax, and that if the donee pays the gift tax, this constitutes income to the donor.

On this theory, however, the income would be the amount of the gift tax without regard to the basis of the donated property, and it would be ordinary income and not capital gain. Nevertheless, the Commissioner contends in such a case that the donor realizes taxable income to the extent only that the amount of the gift tax exceeds the adjusted basis in the donated property and that it is a capital gain rather than ordinary income.

There are several other troubles with this theory. In the first place, the payment of another's tax liability does not necessarily generate income. As pointed out by Judge Haynesworth in *Hirst* (572 F.2d at p. 431) payment of a tax for someone else may be a gift, depending on the circumstances. For example, a parent may pay a daughter's note at a bank as a gift to the daughter. The net gift tax transaction could be characterized as reciprocal gifts, which are netted out for gift tax purposes.

In the second place, it is incorrect to say that the donee is paying the donor's obligation. It is true that the donor is liable for the gift tax if the donee fails to pay, but as between donor and donee, the obligation to pay is that of the donee, if there is any obligation at all. An accommoda-

tion maker of a note to a bank is primarily liable to the bank, but the obligation is really that of the accommodated party and if the latter pays the note, it would be incorrect to say that he is paying the obligation of the accommodation maker. Moreover, in the case of the gift on the condition precedent that the donee pay the gift tax, the gift is not complete until the gift tax is paid and it would therefore be incorrect to say that either the donor or the donee has a prior obligation to pay the tax. The obligation, the payment, and the completion of the gift are all simultaneous.

In the third place, the economic benefit to the donor in a net gift transaction is simply that the donor has made a smaller gift rather than a larger one. He is obviously worse off economically than if he had made no gift, but it would be farfetched to say that although one is better off making a gift of $100 rather than a gift of $200, he realizes taxable income and incurs an income tax in so doing.

Finally, adopting the rationale of *Sarah Helen Harrison* and *Krause,* the donee in a net gift transaction is merely a conduit. The donor furnishes either the funds for payment of the gift taxes or the equivalent in property, which the donee is free to sell to raise the funds.

The Tax Reform Act of 1976

In the Tax Reform Act of 1976, Public Law 94-455, one of the concerns of Congress was "the possible tax abuse where the grantor places in trust property which has unrealized appreciation in order to shift the payment of any capital gains tax to the trust at its lower progressive rate structure." Ways and Means Committee Report [H. Rpt. No. 94-658, 94th Cong. 1st Sess. (November 12, 1975)] p. 183. The final result was Section 701(e) of the Act, incor-

porating a new Section 644 into the Code, whereby "the trust is taxed at the grantor's rate brackets on 'built in' gain occurring within 2 years of transfer to the trust." Conference Report [H. Rpt. No. 94-1515, 94th Cong. 2d Sess. (September 13, 1976)] p. 441.

It is significant that the Commissioner does not contend in the cases under consideration, and has not contended in any of the net gift cases, that the donor is the real taxpayer where the donee sells a part of the donated property to raise the funds for payment of the gift taxes. There is no contention that the capital gain taxes incurred by the donee should be measured by the donor's tax bracket rather than the donee's. If such contention were made, one conclusive answer would be, at least where the donee is a trust, that Section 644 of the Code applies only to transfers to trusts after May 21, 1976. As previously shown, the difference in tax brackets of donor and donee is the source of the Commissioner's dissatisfaction with net gifts and the correlative advantage to taxpayers. This is not to say that in some cases there may not be a practical reason for a net gift, as where the donor does not have the funds to pay the gift taxes and does not want to sell any part of the property, whereas the donee does have the funds; e.g. in *Hirst*, where an 80 year old widow with limited liquid assets gave undeveloped land to her grown son and his family on condition that he pay the gift taxes. But the Commissioner has no just cause for dissatisfaction in such a case because the funds used by the donee are probably the residue of taxable income on which he has previously paid (or will pay) the required income tax, at perhaps a relatively high rate.

Congress was evidently concerned in the Tax Reform Act of 1976 with reforms in this whole area of taxation. Not only did it add Section 644 to the Code, but also by

Section 2005(c) of the Act added to Section 1015(d) of the Code a new paragraph 6, providing a special rule for gifts made after December 31, 1976, as to increased basis for gift tax paid. Instead of increasing the donee's basis by the full amount of the gift tax paid there is added only a proportionate amount bearing the same ratio to the amount of tax paid as the net appreciation in value of the gift bears to the amount of the gift.[3] This has the effect, of course, of lowering the donee's basis and increasing the amount of his capital gain tax when he sells. But Congress did not incorporate into this complex body of tax law the incongruous concept advocated by the Commissioner in these cases.

The Crane Case

In *Johnson* the Sixth Circuit Court of Appeals relied not only on *Old Colony Trust Company*, but on *Crane*. *Crane* was cited for the proposition that a non-recourse encumbrance must be included in the "amount realized on the sale or other disposition of property under Section 1001 (a) of the Code." This Court did make that holding as applied to the facts of the particular case where there was

---

3. The reason for the change was given as follows by the House Ways and Means Committee:

> 4. The basis of property acquired by gift generally is the basis of the property in the hands of the donor plus any gift taxes paid on the gift. The purpose of the increase in basis for gift taxes paid on the gift is to prevent a portion of the appreciation in the gift (equal to the gift tax imposed on the appreciation) from also being subject to income tax, that is, to prevent the imposition of a tax on a tax. However, existing law is too generous in that it permits the basis of the gift property to be increased by the full amount of the gift tax paid on the gift and not just the gift tax attributable to the appreciation at the time of the gift. Consequently, the bill provides that the increase in basis of property acquired by gift is limited to the gift tax attributable to the net appreciation on the gift. H. Rpt. No. 94-1380, 94th Cong., 2d Sess., August 2, 1976 pg. 44 of Rpt.

a sale of property which the taxpayer had inherited subject to a mortgage indebtedness. She had taken sizable depreciation deductions prior to the sale, and then made a sale subject to the mortgage indebtedness which had increased because of accrued and unpaid interest. It does not follow, however, that every "disposition" of property subject to an encumbrance is a taxable event. As pointed out in *Evangelista*, Section 1001(a) simply provides for the computation of the gain after it has been determined under some other section of the Code that the disposition in question was a taxable disposition.[4]

The Court in *Crane* said that the "crux" of the case was "whether the law permits her [the taxpayer] to exclude allowable [depreciation] deductions from consideration in computing gain." (331 U.S. at p. 15). The depreciation deductions actually taken, according to the Tax Court opinion aggregated $28,500, while the allowable depreciation was $28,045.10, which added to the $2,500 cash realization would produce a taxable gain of $30,545.10. On the theory that a non-recourse encumbrance is to be included in the amount realized, the gain should have been the net proceeds of sale plus the total amount of the encumbrance, minus the adjusted basis: $2,500 + $270,857.71 - $233,197.40 = $40,160.31. The amount of the gain actually determined was the net proceeds of sale plus the principal (only) of the encumbrance, minus the adjusted basis: $2,500 + $255,000 - $233,197.40 = $24,302.60. The Court did not concern itself with the minutiae of the computation, but contented itself with accepting the agent's determination.

---

4. "This provision [§1001(a)] is purely computational; it leaves to other provisions the task of determining whether the amount so computed is taxable or deductible, recognized or not recognized, and capital or ordinary." Boris J. Bittker, Federal Taxation of Income, Estates and Trusts (1981) ¶43.1.

The Court, in *Crane*, evidently realizing the potential confusion likely to be engendered by the decision, was careful to point out in Footnote 37 of the opinion what it was *not* deciding. Nevertheless, some subordinate courts, as well as commentators, have attempted to stretch the decision beyond the limits imposed by the Court.[5] Certainly the *Crane* decision is completely inapposite in a case involving a gift of non-depreciable property. Whether or not such cases as *Johnson* were correctly decided is not here at issue; however, if they were correctly decided, it would not be on the authority of *Crane*, but on the principle that one who borrows money on appreciated property, and then makes a gift of it subject to the debt which is in excess of the basis of the property, has realized income to the extent of this excess. It is unnecessary to rely on *Crane* to reach this decision.

The Commissioner is inconsistent in relying upon *Crane* upon the merits and then asserting that the alleged income is realized in the year that the donee pays the gift taxes, rather than in the year of the transfer. Although the Commissioner has made a labored attempt to escape this dilemma, it is submitted that he cannot do so and that by contending that the supposed income was realized in the year of payment rather than in the year of transfer, he has in effect abandoned his reliance on *Crane*. It is interesting to note that the Commissioner at one time recognized the complete inapplicability of *Crane* in the present situation. In *Johnson*, the Solicitor General filed a Memorandum in

---

5. The first sentence in Footnote 7 in the *Owen* opinion (652 F.2d at p. 1275) is an example. The confusion engendered by *Crane* is illustrated in two recent cases in which the courts reached opposite conclusions: *Millar v. Commissioner*, 577 F.2d 212 (3rd Cir. 1978), cert. denied 439 U.S. 1046 (1978) and *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. 1981), where the Court "decline[d] to extend it [the *Crane* decision] beyond the facts of that case."

opposition to the taxpayers' petition for certiorari which had been based, in part, upon an alleged conflict between the Sixth Circuit decision in *Johnson* and the Fifth Circuit decision in *Estate of Davis*. In arguing that there was no conflict, the respondent said:

> Moreover, unlike this case, *Davis* did not involve the transfer of property subject to a pre-existing lien which rendered the amount of the lien an "amount realized" under this Court's *Crane* decision.

Davis is, of course, on all fours with the cases at bar; and if *Davis* was unlike *Johnson*, it follows that the cases at bar are also unlike *Johnson*. In fact, as we see *Johnson*, it bears little resemblance to the net gift type of transaction here involved, but closely resembles such cases as *Simon* and *Magnolia Development Company*.

The Constitutional Concept of Income

A "frequent recurrence to fundamental principles"[6] is equally as essential in jurisprudence as in political and governmental affairs. In Federal income tax cases, Congressional authority stems from the Sixteenth Amendment, and the Internal Revenue Code must be applied so as not to violate the constitutional concept of income.[7] It is a fundamental principle, we submit, that a gift does not

---

6. Paragraph 15 of the Virginia Bill of Rights, 1776, reads as follows:

> That no free government, or the blessings of liberty, can be preserved to any people, but by a firm adherence to justice, moderation, temperance, frugality and virtue, and by frequent recurrence to fundamental principles.

7. Cf., footnote 42 of *Crane*, 331 U.S. 1 at p. 15, *supra*, where, in referring to a hypothetical case, the Court said that it would raise a question as to whether "either statutory or constitutional income" would be realized by the hypothetical taxpayer. This demonstrates that constitutional concepts in income taxation are not obsolete.

give rise to income, in the constitutional sense, either to donor or donee. Nor has Congress undertaken to impose such an income tax, thereby forcing the Commissioner in this case to rely upon the general language of Section 61 that "gross income means all income from whatever source derived."

We respectfully submit that the derivation of income from a transaction which leaves taxpayers "in fact poorer by virtue of the entire transaction" (*Commissioner v. Rail Joint Co.*, 61 F.2d 751 (C.A. 2, 1932)) is completely foreign to the constitutional concept of income under either the Sixteenth Amendment or Section 61 of the Code. The Sixteenth Amendment authorizes the taxation of "income" but it does not authorize the taxation of an integrated transaction which merely leaves the taxpayer better off than he might have been, although worse off than before the transaction was entered into. *Cf., Eleanor A. Bradford v. Commissioner*, 233 F.2d 935 (6th Cir. 1956) opinion by Judge Stewart, later Mr. Justice Stewart. There have been many definitions of "income". Among the cases cited in *Bradford* on that subject was *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940), from which we quote as follows:

> 'Income' within the purview of the Revenue Acts, has been defined to be 'gain derived from capital, from labor, or from both combined,' and includes 'profit gained through sale or conversion of capital.' Bowers v. Kerbaugh Empire Co., 271 U.S. 170, 46 S. Ct. 449, 451, 70 L.Ed. 886. 'In determining the definition of the word "income" thus arrived at, this Court has consistently refused to enter into the refinements of lexicographers or economists, and has approved, in the definitions quoted, what it believed to be the commonly understood meaning of the term which must have been

in the minds of the people when they adopted the Sixteenth Amendment to the Constitution.' Merchants' L. & T. Co. v. Smietanka, 255 U.S. 509, 519, 41 S. Ct. 386, 389, 65 L.Ed. 751, 15 A.L.R. 1305.

It cannot be plausibly argued that the word "income" had, when the Sixteenth Amendment was adopted, the meaning attributed to it by the Commissioner in the instant cases. A donor has the right to determine for himself the extent of his generosity, and if he wishes only to give the value of stock *less the amount of the gift taxes payable by reason of the gift,* it is difficult to understand how he can be said to have realized income merely because the amount of the gift taxes exceeds the cost of the stock.

On the constitutional concept of income, we refer the Court to *Edwards v. Cuba Railroad,* 268 U.S. 628 (1924), where the Court said: "The Sixteenth Amendment, like other laws authorizing or imposing taxes, is to be taken as written and is not to be extended beyond the meaning clearly indicated by the language used." (p. 631). The Court held that subsidy payments to the railroad company "not made for services rendered or to be rendered" were not "profits or gains from the use of the railroad, and do not constitute income within the meaning of the Sixteenth Amendment." (p. 633).

The Weight to Be Given the Tax Court Decisions

At the time the transfers of the *amici curiae* were made, the Commissioner had apparently abandoned, at least in the Sixth Circuit, the contention that a net gift results in the realization of income to the donor in any case except one controlled by Code Sections 671 and 677. Having appealed the decision of the Tax Court in *Krause,* he permitted his appeal to be dismissed on June 27, 1972 for want of prosecution. This left the decision in *Turner* as

the unchallenged authority on the issue in the Sixth Circuit. Moreover, the Fifth Circuit Court of Appeals had affirmed *Estate of Davis.*

The rule of *stare decisis* is peculiarly applicable with respect to judicial decisions affecting the business interests of the country, estate planning, income taxation and the like. The reason was aptly stated in *United States v. Byrum,* 408 U.S. 125 (1972), where the Commissioner, in a case involving Section 2036(a)(2) of the Code, sought to impose an estate tax on trust property on the ground that the settlor retained voting control of corporations whose stock was transferred, and was in position to select the corporate directors who, in turn, passed on dividend policy. Citing *Reinecke v. Northern Trust Company,* 278 U.S. 339 (1929) and *Estate of King v. Commissioner,* 37 T.C. 973 (1962), the Court said (p. 134):

> Essentially the power retained by Byrum is the same managerial power retained by the settlors in *Northern Trust* and in *King.* Although neither case controls this one—*Northern Trust,* because it was not decided under § 2036(a)(2) or a predecessor; and *King,* because it is a lower court opinion—the existence of such precedents carries weight. The holding of *Northern Trust,* that the settlor of a trust may retain broad powers of management without adverse estate-tax consequences, may have been relied upon in the drafting of hundreds of *inter vivos* trusts. The modification of this principle now sought by the Government could have a seriously adverse impact, especially upon settlors (and their estates) who happen to have been "controlling" stockholders of a closely held corporation. Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxa-

tion requires reexamination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

This was not a new application of *stare decisis*. In *National Bank v. Whitney*, 103 U.S. (13 Otto) 99 (1880), the Court was confronted with a contention that real estate mortgages taken by national banks to secure future advances on loans were *ultra vires* and unenforceable. There had been a decision two years previously to the effect that the prohibitory clause of the banking law with respect to loans on real estate did not vitiate real estate securities taken for loans, but "only laid the association open to proceedings by the government." In the case before it, the Court said:

> The construction of the act of Congress thus given has been acted upon by the national banks throughout the country ever since it was published. It is not unreasonable to suppose that they have conducted their business and made loans to a large amount in reliance upon it, and that in many cases great injury would follow a departure from it. Judicial decisions affecting the business interests of the country should not be disturbed except for the most cogent reasons, certainly not because of subsequent doubts as to their soundness. The prosperity of a commercial community depends in a great degree, upon the stability of the rules by which its transactions are governed. If there should be a change, the legislature can make it with infinitely

less derangement of those interests than would follow a new ruling of the court, for statutory regulations would operate only in the future.

The statement most often quoted on *stare decisis* is that of Justice Brandeis in his dissenting opinion in *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932). "*Stare decisis* is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right. This is commonly true even where the error is a matter of serious concern, provided correction can be had by legislation."

It is recognized, of course, that this Court has not previously spoken on the issue presented, so that *stare decisis* in the usual setting is not applicable. Nevertheless, the principles of Federal tax law relied upon by the taxpayers were firmly embedded in the court with special expertise in tax matters,[8] with the concurrence of two Circuit Courts of Appeal, including that of the Circuit where the *amici curiae* resided. Judge Edwards, of the Sixth Circuit, in his dissenting opinion in *Owen*, apparently recognized the inequity of a retroactive reversal of *Turner*, and we urge upon the Court that should the decision be to affirm the present cases from the Eighth Circuit, reversing the Tax Court, the reversal of the Tax Court should

---

8. Mr. Justice Jackson, dissenting, in *Arrowsmith v. Commissioner*, 344 U.S. 6, 12 (1952): "Where the statute is so indecisive and the importance of a particular holding lies in its rational and harmonious relation to the general scheme of the tax law, I think great deference is due the twice-expressed judgment of the Tax Court. In spite of the gelding of *Dobson v. Commissioner*, 320 U.S. 489 (1943), by the recent revision of the Judicial Code, Act of June 25, 1948, 36, 62 Stat. 991-992, I still think the Tax Court is a more competent and steady influence toward a systematic body of tax law than our sporadic omnipotence in a field beset with invisible boomerangs. I should reverse, in reliance upon the Tax Court's judgment more, perhaps, than my own." The Tax Court has expressed its judgment on the net gift issue in not less than twelve cases.

be non-retroactive. The criteria outlined in *Chevron Oil Company v. Huson*, 404 U.S. 97, 105-109 (1971) are clearly met.

This, however, is a case where the remedy, if one is needed, should be with Congress—not with this Court. *Hanover Bank, Executor v. Commissioner*, 369 U.S. 672 (1962). Actually, as previously shown, Congress has already, in the Tax Reform Act of 1976, adopted the reforms it considered necessary, but the one proposed by the Commissioner was not one of them.

In 1974, Judge Raum commented in *Hirst* (63 T.C. at p. 315) that it was "now too late to wipe the slate clean and start all over again." In view of the Tax Reform Act of 1976, it is now impossible to wipe it clean and start all over again. The petitioners in this case, and the *amici curiae*, all followed both the statute law and the judge-made law as it existed at the time they made their gifts, and that is the law which should now be applied.

CONCLUSION

The decisions of the Eighth Circuit Court of Appeals, reversing the Tax Court, should be reversed, but if affirmed, the reversals of the Tax Court should be non-retroactive.

Respectfully submitted,

WILLIAM WALLER
(Counsel of Record)
WALLER LANSDEN DORTCH & DAVIS
2100 One Commerce Place
Nashville, Tennessee 37239
(615) 244-6380
Attorney for Amici Curiae

Dated: November 18, 1981